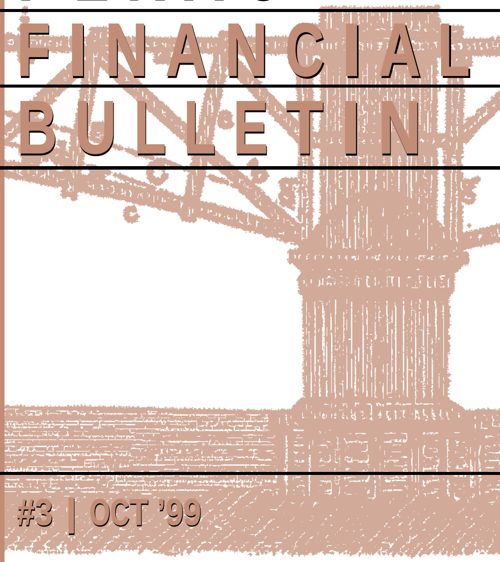
THE PERAC FINANCIAL BULLETIN



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PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

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PUBLISHED BY THE PERAC COMMUNICATIONS UNIT

Financial Market Review Third Quarter, 1999

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BUFFETED BY FEARS OF HIGHER INTEREST RATES and worried about the effects of a huge trade deficit and a weaker dollar, the US stock market gave back a good amount of its earlier gains during the third quarter. With worries over possible Y2K disruptions and concern over historically high valuations of most US stocks, investors were committing money to the market at only half the rate of 1998.

With most stocks off 10-20% from highs that were reached in mid-July, the technology-laden NASDAQ Composite Index was the only broad market index to register a positive return for the quarter. The encouraging signs of broader market participation during the second quarter—when value stocks had outperformed growth stocks and small stocks had outperformed large stocks—were decisively reversed during the third quarter. Among the market's most discouraging aspects was that the quarter's best performing stocks were concentrated in a few large cap names, masking the fact that the market on the whole was actually doing worse than indicated by the major indices. In fact, the individual stocks of the S&P 500 were off an average of 23.5% from their highs of the previous twelve months, and more than 60% of all stocks on the New York Stock Exchange were down for the year at quarter-end, as were six of the ten major S&P 500 industry groups. Bank stocks and health stocks (including drug stocks) have been particularly weak. Even such dependable market stalwarts as Coca-Cola and Gillette are off more than 20% this year. Perhaps most startling of all, about half the stocks on the NASDAQ are down for the year even though the NASDAQ Composite Index is up 25.2%.

Technology continues to be the one sector to show strong performance. After posting a rise of 29% through the first three quarters of the year, the tech sector now represents almost 25% of the value of the S&P 500, up from 13% at year-end 1997 and just 7% in 1990. The only time one sector similarly dominated the S&P was when energy stocks represented 27% of the index in 1990, when oil was $40 a barrel. Were it not for technology stocks, the S&P 500 would have been down about 2% for the year at quarter-end.

Near the end of the quarter, the tech sector was shaken by the surprising remarks of Microsoft President Steven Ballmer, who declared in a speech that "There's such an overvaluation of tech stocks it's absurd, and I'd put our company's stock in that category." The sector stabilized in the weeks following Mr. Ballmer's remarks, and time will tell whether his warning will prove prophetic. Many market strategists point [CONTINUED ON PAGE 2]

> **As the countdown began** toward the end of the century—and the end of a decade of historically high returns, it appeared increasingly likely that 1999 might go down as a year in which investors were reminded that stocks do not always produce double digit returns.

[FROM PAGE 1] out, however, that although the valuations of many tech stocks may indeed be sky-high, the group continues to register extremely impressive profit growth well above that of any other sector.

Proponents of international diversification found satisfaction during the quarter as the Morgan Stanley EAFE Index outperformed all domestic indices. The Japanese stock market continued to awaken from its decade-long swoon; for the year, it is up more than 43% in dollar terms. European markets continued to be lackluster although some analysts feel that their prospects have become more favorable. Emerging markets gave back some of their explosive gains registered earlier this year, but are still up impressively for the year.

The bond market was little changed with mixed results during the quarter as interest rates rose somewhat further. The market struggled with fears that the economy's consistent and impressive strength would cause the Federal Reserve to continue to tighten monetary policy in an effort to dampen expectations of future inflation. The benchmark long Treasury bond which began the year at 5.10% and rose to 5.96% at mid-year finished the third quarter at 6.04% although it traded in the 6.10% range in the days before and after quarter-end. Corporate bond yields rose under pressure of heavy supply, much of which was thought to be initiated by corporate treasurers seeking to avoid possible year-end turbulence in the markets. In the high-yield corporate market, issuers in the lower ranges of quality within this category found the market increasingly unreceptive. An apparent decline in credit quality, surprising in light of overall economic expansion, weighed against all but the highest quality corporate bonds; not only have downgrades by the rating agencies far exceeded upgrades but the default rate, while still low, has been rising.

When the Fed announced on October 5 that it was leaving rates unchanged but adopting a bias toward future increases if signs of inflation were to emerge, the markets began the fourth quarter with a weak and nervous tone. Despite an economic expansion of unprecedented duration and an official rate of inflation that remained low despite a modest year-to-year increase, investors faced an uncertain landscape. As the countdown began toward the end of the century—and the end of a decade of historically high returns, it appeared increasingly likely that 1999 might go down as a year in which investors were reminded that stocks do not always produce double digit returns. Sometimes they go sideways…and sometimes they even go down. ◆

PLEASE NOTE:

The PERAC Investment Unit welcomes any comments you may have on this report and encourages all boards to contact us at any time for assistance relating to investment activities. Extra copies of this report are available

THIRD QUARTER, 1999

U.S. EQUITY MARKET

INDEX	DESCRIPTION	3RD QUARTER RETURN	YEAR-TO-DATE, 1999
DOW JONES INDUSTRIAL AVG.	30 INDUSTRIAL STOCKS	– 5.39%	13.96%
STANDARD & POOR'S 500	LARGE CAP STOCKS	– 6.24%	5.36%
NASDAQ COMPOSITE	TECHNOLOGY-DOMINATED	+2.24%	25.24%
WILSHIRE 5000	BROAD MARKET INDEX	– 6.61%	4.47%
S&P MIDCAP 400		– 8.40%	– 2.10%
RUSSELL 2000	SMALL CAP STOCKS	– 6.32%	2.37%

GROWTH vs VALUE

	3RD QUARTER	YEAR-TO-DATE
S&P 500 GROWTH	– 3.49%	7.10%
S&P 500 VALUE	– 9.23%	3.44%

GLOBAL MARKETS

	3RD QUARTER	YEAR-TO-DATE
M.S.C.I. - E.A.F.E.	4.03%	7.40%
M.S.C.I. - EMERGING MARKETS	– 5.42%	33.30%

REAL ESTATE

	3RD QUARTER	YEAR-TO-DATE
NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	– 8.04%	– 3.65%
NCREIF PROPERTY INDEX	N.A.	5.09% thru Q2

FIXED INCOME MARKET

	3RD QUARTER	YEAR-TO-DATE
LEHMAN BROTHERS AGGREGATE INDEX	0.68%	– 0.71%
LEHMAN BROTHERS CORPORATE INDEX	0.29%	– 1.97%
LEHMAN BROTHERS GOVERNMENT INDEX	0.66%	– 1.63%
LEHMAN BROTHERS MORTGAGE INDEX	0.93%	+1.46%
FIRST BOSTON HIGH-YIELD INDEX	– 1.60%	+1.17%

GLOSSARY

Dow Jones Industrial Average: A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal*.

Standard & Poor's 500 Index: A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ: The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000: The major index that tracks small capitalization stocks.

Large Capitalization Stock: Total market value of outstanding stock exceeds $5 billion.

Mid-cap stock: Between $1.5-5 billion in market capitalization.

Small-cap stock: Less than $1.5 billion market value of stock outstanding.

Growth stock: Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value stock: Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio: Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury yield: The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

Corporate bond spread: The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate: The rate at which reserve funds ($1 million or more) are traded among commercial banks on an overnight basis

High-yield ("junk") bonds: Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.